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General Business Conditions

THE second month of war has passed without visible abatement of the high spirit of unity and determination aroused by the attack on Pearl Harbor. The gigantic war program, as laid down in the President's address to Congress and the budget message, was welcomed everywhere as setting forth objectives worthy of the country's power and resources, and the markets received the fiscal proposals without shock, despite the almost incomprehensible totals of the estimated expenditures, debts and taxes. The President asked for 60,000 airplanes in 1942 and 125,000 in 1943; for 45,000 tanks in 1942 and 75,000 in 1943; and for other arms and ships in proportion. The airplane goal for this year is more than two and a half times the annual rate last September, the last month for which production figures were published, and in some other arms the projected increases are still greater. To carry out the two-year program, reliable estimates indicate that the normal output of the metal-working industries will have to be doubled.

Mr. Churchill, after his return from the United States, described this program as "staggering." Nothing like it has ever been attempted anywhere, and it is not surprising that many people regard the goals as out of reach. It may be recalled that surveys of port and shipping facilities, made after our entry in the last war, concluded that we could not possibly transport and maintain two million men in France. But it was done. With energy and determination we can do the seemingly impossible again and the situation demands it.

Since Pearl Harbor the industrial effort has gained momentum. Contract placements have been speeded, aggregate production has increased despite the curtailment in some lines, and more of the output is in war goods. Immense new armament projects are under way, particularly in the automobile industry and its allied metal-working plants. Technical progress in production methods, as skilled production people apply their experience and resourcefulness to what are now common problems, is helping to speed output; also, it is a permanent gain for future generations.

Finally, confidence in the effectiveness of the war effort has been increased by the formation of the War Production Board and the delegation to Mr. Nelson of executive powers, subordinate only to the President, which give him direction of procurement and production. The criss-crossing of duties and of authority in the administration of the program had produced such confusion and delays that a change was imperative, for its success was jeopardized. Now the program will have a responsible head, with power to cut knots and to make vital decisions.

Concentration on War Production

In domestic business the moves to concentrate the industrial effort on war production overshadow other developments. They require loyal and efficient co-operation from the public as well as the industries, and they are receiving it in gratifying measure. Limitation and curtailment orders are spreading as time goes on and disrupting many normal occupations, but they are accepted in good spirit, as inevitable and as furthering the war effort; and of course the situation provides the strongest possible inducement to employers and workers to get into war production.

Probably many people who are now being put out of jobs by "priorities unemployment" feel that they are bearing a disproportionate part of the war burden, which is plainly true when their lot is contrasted with that of defense workers and farmers. However, there is in the aggregate more work to be done than ever before. In due course the people now bearing the brunt of the changeover will be largely absorbed in war work. This is precisely what is wanted, and the sooner it can be brought about the nearer the war will be to a successful conclusion.

Restrictions on production of civilian goods and on purchases of scarce commodities will be borne cheerfully. It would be too much to say that there is universal understanding of

everything that people should do to support and finance the war effort, for otherwise there would be less inclination by groups and individuals to seek advantage for themselves, and less need for government to intervene. However, when the Government takes the lead — whether in moves to rush conversion of plants to war uses, to limit consumption of scarce materials, or to assure the best possible distribution of supplies — there is general co-operation. The great majority of people will make sacrifices for the war effort gladly, and while it is regrettable that lack of understanding or unwillingness to go along on the part of a few requires government intervention, it is not only fair but necessary that everyone shall bear an equitable part.

Evidence of public response to the country's war need is found in the sales of defense bonds and stamps, which jumped from $238,000,000 in November to $536,000,000 in December and may exceed $1,000,000,000 for January. While some of this is a shift of previous savings out of other investments, much represents the more desirable savings from current income. What is wanted, of course, is current savings, which means abstaining from consumption, reducing the demand for consumer goods, and making the money available to pay for tanks and guns. This is being achieved in increasing amounts through the payroll deduction programs.

Passenger Car Output Suspended

Automobile workers are now the most conspicuous victims of priorities. The curtailment begun to save steel and non-ferrous metals has been turned, by the need to save rubber, into complete suspension of passenger car output, beginning in February. The automobile industry will carry a greater part of the armament program than any other industry, and the question of how completely and rapidly its resources can be turned to armament production has become almost a political issue.

One statement may be made confidently. No one can convert the automobile industry to war work more quickly than its own experienced officials, and Mr. Nelson has been widely commended for basing his policies toward the industry on that fact, — giving it big jobs to do, appointing an able executive as co-ordinator, and letting it go to work. In all likelihood it will be turning out, a year or so from now, arms production of a greater value than the automobile output of its biggest year, and giving more employment than at any previous peak.

But although in the long run the country can expect a very great deal from the motor industry, it should not expect too much too rapidly, over and above the previous program. Controversy centers around the extent to which equipment can be put to armament work, but as Mr. C. E. Wilson, President of the General Motors Corporation, has pointed out, there is no single answer. If the industry were making battleships it could use virtually none of its facilities, but in making army trucks it can use 95 to 97 per cent. General Motors is now undertaking a huge tank contract, and Mr. Wilson has said that while parts production will be distributed through existing plants, the assembly unit and the big part of the work will require a new plant and new facilities. In producing airplane motors, which is high precision work, and heavy ordnance, the industry has been able to use little of its equipment and has had to construct new plants. War production gives little use for the big punch presses and other specialized machines needed for mass automobile output, or for assembly equipment. The materials used in armaments are in many cases not the same as those which automobile plants are designed to use — aluminum for airplanes instead of sheet steel, and cast steel and alloy steel for tanks and ordnance instead of cast iron — and fabricating methods differ. Some of the differences, to be sure, are not of prohibitive importance; automobile body plants produce sub-assemblies for planes and are making a vital contribution to the bomber program.

Another consideration is that the part of the present equipment which eventually can be used cannot be put to work effectively until new machines and tools necessary to balance the production are ready. Many of the machines needed will be of types heavier than are employed in the automobile industry, and they are the most difficult to obtain.

The Industrial Pattern

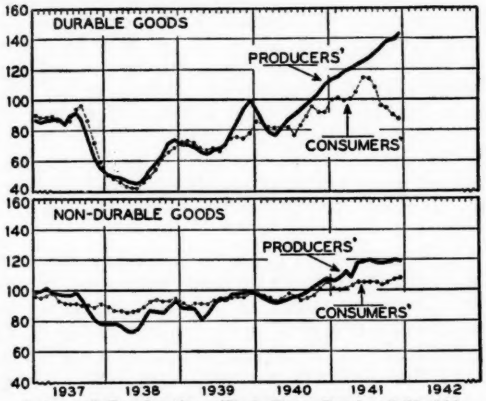
The automobile situation illustrates the prospective industrial pattern for the duration of the war. The industries making consumers' goods which use scarce materials will be curtailed either by direct limitation of operations, as in the case of refrigerators, washing machines, radios for civilian use, and others; or by increasing restrictions on the use of materials. On the other hand, production for direct war use will rise, and should be trebled in 1942 as compared with 1941, if the war program is effectively carried out.

Some part of the increase in arms production doubtless will be achieved by expanding overall industrial output rather than by diverting facilities from civilian use. Resources of labor and equipment and sufficient raw materials, in the aggregate, are available for further expansion. However, it is a reasonable estimate that after the government orders are supplied the industrial product remaining will aggregate something like 30 per cent less than 1941, which of course was the all-time record year, and that it will be somewhat below the average of the years 1935-39.

Furthermore, the makeup of this civilian production, in terms of various types of goods,

will be considerably different than in the pre-war years. Production of most non-durable goods of everyday use, including manufactured foods, shoes and textiles as a whole, will be at high levels, even after deducting Army and lend-lease needs. It will be necessary to maintain and expand railroad and utility equipment, private industrial plant, and to a considerable extent farm machinery, all of which are essential in carrying out the war effort and therefore are indirectly for war use. Hence the bulk of the curtailment will fall on consumers' durable goods.

These trends have been clearly established for several months. We give herewith a chart of industrial production as divided between producers' and consumers' durable and non-durable goods, measured by an index compiled by the Federal Reserve Bank of New York. This index differs from the better known index of industrial production compiled by the Federal Reserve Board, in that it is adjusted not only for seasonal influences but for the long-term trend, so that the base line of 100 represents a calculated "normal".



Index of Production (Fed. Res. Bank of N. Y.)
100 = Estimated Long Term Trend

The drop in consumers' durable goods is already striking, and obviously it will go further. Meanwhile consumers are unusually well supplied with these goods. As a whole, they will go through 1942 with remarkably little decrease in their real satisfactions and enjoyments, something which can be said of no other country. To be sure, they will be living on inventory, with respect to automobiles, tires and a good many other products.

1941 Business Profits

The early reports of corporations for the year 1941 reflect the further rise in volume of sales, in most cases to new high records, but reveal that the margins of net profit per unit of product in a growing number of lines are being narrowed by the rise of operating costs and taxes, as well as by the transition to defense work. In the manufacturing industries, the figures available thus far indicate that the final quarter of 1941 showed little or no gain in net profit over the corresponding quarter of 1940, and that the increases shown for the full year 1941 were confined for the most part to the first three quarters.

For a limited group of manufacturing companies which have already issued reports giving tax figures for the year ended December 31, the income and excess profits taxes more than trebled. They took 50 per cent of the net income before taxes, in contrast with 25 per cent in 1940. For the full year taxes absorbed 82 per cent of the increase in net income before taxes. This cut an increase of 77 per cent in net income before taxes to an increase of 18 per cent after taxes.

Earnings statements for companies whose fiscal years closed prior to December 31, and which were therefore subject to the lower tax rates imposed by the Revenue Acts of 1940, differ considerably from those whose fiscal years ended December 31. A separate tabulation of 425 manufacturing companies having fiscal years ended June 30 to November 30 showed an increase of 39 per cent over the previous year in their combined net profit after taxes. Earnings of such companies have of course become subject in the current fiscal year to the higher tax rates of the Revenue Act of 1941 as well as to the factors that are narrowing profit margins generally.

In lines other than manufacturing, the annual reports now being issued indicate highly uneven changes in net profits, ranging from sharp recovery by many of the borderline railroads to moderate declines by some of the leading public utility systems. As more reports become available, they will be shown in our regular summaries in the March and April issues.

The Price Control Act

The price control bill, which has been the subject of acrimonious controversy ever since it was introduced in Congress last August, was finally agreed upon by the conferees on January 22nd. After acceptance by the House and Senate it was signed by the President on the 30th, with a statement of criticism respecting the farm price provisions. It is safe to say that no one is much pleased by the Act, not even the administrator upon whom it confers great powers. For the present, however, enactment of the bill stops debate. The question still unsettled is what are the objectives and the practicable area of price control, and what criteria should be used in the exercise of the administrator's powers.

Of course, the major objective of price control is to avert or restrain an inflationary rise of prices, which would add to the cost of the war effort, cause disorder in business, and finally

put the general price level on stilts, with calamitous consequences. It is generally agreed, however, that this major objective is beyond the reach of price controls alone; regulation of every kind of price and business transaction would be required, and even if this were otherwise practicable it could not be done under an Act which restricts control of farm prices and from which wages are excluded. The moves against inflation must come from all sides. Fundamentally, the way to combat it is to produce more, save, keep costs down, and establish a fiscal policy which will absorb excess purchasing power into the Treasury.

The practicable objectives of direct price controls therefore are limited. Chiefly they can be used to restrain price rises where price rises are not necessary either to maintain or increase production, and to remove the incentive to hoarding and withholding supplies. If they can be effective over basic commodities in general, and over important classes of goods in the early stages of manufacture, they can do a great deal to restrain increases in prices of a multitude of finished goods, whose control would be a formidable and forbidding task. Price controls are obviously desirable when commodities essential either to the war effort or to public health are allocated or rationed, for it would be against common sense to allow people to bid against each other under such conditions.

Natural Functions of Prices

On the other hand, it should be plain that if the controls do not recognize the natural functions of prices they will not work as intended. If they do not give sufficient inducement to maintain production or to expand it where necessary, they will nullify other efforts to increase the national output. If cost relationships are disrupted production will be disturbed, and if price relations in general are violently distorted grave problems of post-war adjustment will be created. If profits permitted to producers fail to provide adequate reserves against extraordinary war costs and against post-war contingencies they will contribute to post-war instability and financial weakness. In some lines there will be sound reason why the function of restricting consumption may be best performed by higher prices, provided other conditions are present to check any shift of enterprise and labor into such lines, away from the war effort.

These considerations show that the effectiveness of price controls will depend upon the wisdom with which they are administered, also upon the co-operation accorded. In the areas in which Mr. Henderson has worked co-operation has been good with few exceptions. Not all of his orders have been whole-heartedly approved by the trades concerned, but he has recognized that the chief need of the war program is to get production. He has lifted the ceilings on lead, zinc and some other metals, as well as other goods, when it has become clear that production could be increased by doing so, and has sponsored subsidy arrangements for high-cost producers. These arrangements are now being put into effect, although after long delay, in copper, lead and zinc. Even with the higher ceilings the critical metals have had no such rise as in the corresponding time in the last war, and the same is true of semi-manufactured goods in general, coal and oil.

The Farm Price Provisions

For many months the upward movement in prices has been led by farm products, and as far as Mr. Henderson's powers are concerned this rise can continue, for he is stopped from placing ceilings on farm products below the highest of the following points: (1) 110 per cent of "parity", the term used to signify the same relation between farm prices and prices of things farmers buy as existed in 1909-14; (2) the October 1, 1941, price; (3) the December 15, 1941, price; (4) the 1919-29 average. According to this formula, there would be room for advances in a majority of farm commodities, ranging from about 10 per cent in cotton to about 40 per cent in corn, before ceilings could even be considered. Moreover, no ceilings can be established without Secretary of Agriculture Wickard's approval, and it should be understood that "parity" is not static, but moves up as prices of goods farmers buy move up. If these rise, permissible price ceilings also will rise.

The veto power given to Secretary Wickard has been the subject of much comment. But if the Secretary sticks to his recorded views he will not be averse to price ceilings at the levels permitted. In his annual report just issued he says that "efforts to push farm prices above parity may endanger the parity principle itself;" and in a speech at Atlanta, January 28, he said "Let us be satisfied with parity . . . I am going to do all that I can to keep prices from going much beyond parity." Practical evidence of his intention is found in the current policy of the Commodity Credit Corporation, which is selling the government-owned wheat and corn to the extent that the market will take them, and cotton to the extent permitted by law (300,000 bales monthly). Although the price of corn is below parity, the Secretary has denounced the recent rise in corn as speculative, and as endangering production of livestock, dairy and poultry products, and has called attention to the abundant supply.

Furthermore, Secretary Wickard has been vigorous in programs for larger production. Farm production goals were raised last September and again during the past month. Since the greatest need now, in view of the loss of coconut, palm and tung oil imports, is for in-

creased domestic production of fats and oils, the program asks for 5,000,000 acres of peanuts for oil, 9,000,000 acres of soybeans, and 4,500,000 acres of flaxseed. As a price incentive, the 1942 loan rates will be raised. These acreages are by far the largest ever planted to these crops, and will be difficult to reach. Also increases are called for in cotton and corn acreage, which in the September schedules were unchanged from 1941. The hog slaughter goal, as well as that for dairy and poultry products, is well above any production of the past.

The Inflationary Spiral

If the rise in farm prices is to be checked short of the permissible ceilings, the soundest way to do it is through increasing production and selling government stocks. Meanwhile the restrictions on farm ceilings constitute one of the two grave weaknesses of the Act. The fact that "parity" prices rise with other prices makes the parity formula a perfect device for contributing to the inflationary spiral, and the rise to date in the cost of living, which has been more in foods than in other items, is prompting labor to make fresh wage demands. The executive board of the Congress of Industrial Organizations, meeting in New York on the 26th, called on all its affiliated unions to demand substantial wage increases whenever new agreements are negotiated with employers. The danger is that if these increases are granted they will raise prices, farm price parities and permissible ceilings will also rise, the cost of living will advance, and the cycle will be repeated.

According to past experience direct price controls, to the extent permitted by the Act, will not be able to deal effectively with an inflationary spiral. The Act leaves the real burden upon the Treasury and Congress, which determine fiscal policy, and upon individuals. There is need for co-operation, restraint, economy, saving and production.

The Fiscal Problem

The announcement by the President of revised budget estimates for the current fiscal year ending June 30, and of the estimates for the fiscal year following, found the public prepared to accept calmly the enormous totals revealed. As war expenditures have mounted in other countries, and as our own arms program has grown in size, people have been learning of the colossal cost of modern war. Hence the figures, as given out, have served less to alter general conception of the magnitude of the fiscal problem than to define it in somewhat more concrete terms.

While any attempt to go very far into the complex details of the budget obviously is impossible here, a brief review of the major outlines of the estimates may serve as a prelude to discussion of some of the principles involved in the fiscal task ahead.

Dealing only in aggregates, the figures boil down to the following:

(In Millions of Dollars)

	Fiscal 1941 Actual	Fiscal 1942 Estimates	Fiscal 1943 Estimates
Net receipts	7,607	11,944	16,487
Expenditures	12,710	30,576	58,928
Defense	6,301	23,997	52,786
Other	6,409	6,579	6,142
Deficit under present taxes	5,103	18,632	42,441
Proposed new 1943 taxes..	....	....	7,000
Deficit under proposed taxes	5,103	18,632	35,441
Public debt at end of year	48,961	70,612	110,421

In brief, the President foresees defense expenditures almost quadrupling in the current fiscal year over the fiscal year 1941, and considerably more than doubling again in 1943. Other expenditures are expected to be up a little this year, and down about $400 millions in 1943; contemplated savings of $900 millions in various non-defense items in the latter year being partly offset by increased interest requirements on the national debt.

Notwithstanding the swelling of revenue receipts, under the influence of the current record high tax rates and rising national income, to levels far exceeding anything previously reached in this country, the deficit — barring additional taxes — is expected to more than treble this year to over $18 billions, and to much more than double again in 1943 to roughly $42 billions.

In order to reduce somewhat this immense and steadily widening gap between receipts and expenditures, the President proposed $7 billions of new taxes to be collected in the fiscal year 1943, and calculated to reduce the expected deficit in that year to somewhat above $35 billions. In addition, he proposes to raise $2 billions more income through social security taxes which, while not affecting the deficit or volume of the public debt, will reduce the quantity of public debt securities to be placed with the public.

On the basis of these figures, it appears that the Treasury will be covering about 40 per cent of the budget by taxes and the balance by borrowing, compared with the original goal of two-thirds taxes and one-third borrowing for the smaller prewar program. Total federal direct debt by June 30, 1943 is expected to reach $110 billions, including conversion of agency obligations under the recently announced plan of consolidating federal borrowing into Treasury issues.

The Basic Problem

So much for the bare outlines of the program. How can these vast sums be raised?

In tackling this problem, it may be clarifying to begin by stating the objectives. What are we trying to do?

It will be generally agreed that the primary objective is to avoid inflation, with its devastating effects now and in the future and its impairment of the defense effort itself. To do this it is desirable to follow a pay-as-you-go policy as far as possible, both to avoid piling up debt too fast and to prevent the huge sums being spent by the Government from adding to public buying power at a time when supplies of goods for public consumption are running short.

Obviously, however, we cannot pay the whole cost of the war out of current taxes; some part will have to be financed by borrowing. Indeed, from the program outlined above, it may be seen that borrowings this fiscal year are expected to exceed $18 billions, and in the fiscal year 1943 to exceed $35 billions, even after allowing for $7 billions of new taxes.

All this makes more essential the shaping of borrowing and taxing policies in ways to limit as far as possible the inflationary effects of these huge deficits. Much of this new spending power must be sterilized, or it will compete for the limited amount of goods and prices will surely rise.

This sets an entirely new objective of fiscal policy. For ten years government policies have been shaped to the avowed purpose of stimulating buying power. Now, exactly the opposite is necessary. Buying power is too great, and we must reduce it and check spending.

This implies two types of action —

It means, first, that borrowings should be as far as possible out of savings from current income withheld from consumption. Every effort must be made to extend the sale of defense savings bonds, especially in industrial regions where the creation of new purchasing power through increased payrolls has been the greatest. Money spent for defense bonds cannot be spent for goods. Treasury financing should be adapted to the special needs of other types of investors—the insurance companies, savings banks, trust funds, etc., including corporations having temporarily idle balances. While the banks undoubtedly will be called upon to take large amounts of new federal debt, other buyers must be sought if creation of new purchasing power through credit expansion is to be held in check.

It means, second, a new kind of taxation. The present tax structure was designed to get money with the least possible interference with consumer buying power. Higher corporation taxes and higher individual taxes on large incomes will not accomplish the purpose, because by and large they do not reduce spending, but they rather reduce saving. The need now is for more saving and less spending.

What Kinds of Taxes?

The present task is to find where additional buying power is being created by the defense program and apply the taxes at that point. There is no real question where this point is. It is primarily in industrial payrolls, and secondarily in larger corporation profits and farm income. Since corporation profits are already so heavily taxed as to take off most of the increase, the higher payrolls must be looked to as the buying power which will create inflation unless it is recaptured by the Treasury in taxes or diverted into savings.

Another difficulty about the customary corporation and individual income taxes is that they are too slow. Not only is there need to mop up purchasing power where it exists, but also to do it quickly. The Treasury should not have to wait a year to get the money in. The need is for taxes that can be applied promptly and bring an immediate return.

Two forms of taxes would do what is required, a general withholding tax on the gross income of individuals deducted at the source and/or a general sales tax. Both would be effective over a broad base and could be put into operation immediately. As indicated in a following article on Canadian wartime economic policies, Canada employs both a withholding tax and a sales tax. Our social security taxes, which the President recommends be increased and the coverage extended, are withholding taxes; thus a mechanism exists that has already been tested for collecting this type of taxes.

As between a general withholding tax and a general sales — or consumption — tax, there is much to be said for the latter. Its impact upon the taxpayer is less severe. In fact even in the case of food where there is the most question, the effect of a moderate sales tax would be far less burdensome to the consumer than recent farm legislation affecting the cost of farm products. The sales tax, moreover, leaves the payer of the tax with some choice as to how much he pays. There is a kind of automatic adjustment of the tax to ability to pay, whereas in the case of a withholding tax it is almost impossible to make adjustments; an individual with no increase in salary may have to pay the same tax as an individual whose salary has been doubled. The sales tax also has the advantage of taxing spending directly, and it is spending that must be diminished. The sales tax encourages saving.

Both the withholding tax and the sales tax are objected to on the ground that they tend to promote an inflationary spiral, — the one by promoting demands for compensating wage increases, and the other by affecting cost of living indexes, and in turn leading to a new round of wage increases. On the other hand, unless something is done to mop up excess pur-

chasing power where it exists, inflation is still more certain and the Treasury will not even gain the benefit of the tax.

Another objection often made against these taxes is that they discriminate unfairly against the low income groups. But this overlooks several important considerations:

(1) The purpose of inflation-preventive taxation. Unless taxes are levied in a form to affect mass spending and consumption their very purpose as an inflation preventive is lost.

(2) The incomes out of which these taxes would be paid are by and large substantially increased.

(3) These taxes would not be levied alone, but along with the already very high corporation and personal income taxes in the high brackets. As the President pointed out in his budget message, taxes on incomes, estates, and corporate profits have shown the greatest increase since our armament program began. Yields from employment taxes have increased half as fast; yields from excise taxes have increased more slowly; customs have fallen off. In other words, as the President pointed out, our tax system on the whole has become more progressive — that is, it places an increasing load on the corporations and higher individual incomes which, as already indicated, are not the chief source of current spending.

The suggestion frequently made that the tax base be broadened by a lowering of present exemptions on the regular individual income tax has much merit, but also certain drawbacks. The increased yield from lowering exemptions would come largely from those already paying the tax rather than from new taxpayers; the tax in this form is very expensive to collect, involving several million additional tax returns; and it would not be collected until a year hence, whereas we need the money now.

Other Tax Proposals

The foregoing discussion of withholding taxes and sales taxes does not necessarily mean, of course, that other forms of taxes should not be increased. Obviously we need all the money that we can get and everyone must expect to bear his fair share of the burden. The whole field of tax possibilities should be carefully explored; if the corporations can pay more without impairment of effective operations they should do so, and if present tax laws give unfair advantages to certain taxpayers they should be corrected as far as possible.

However, in seeking increased revenues, it is important to give full consideration to the true facts, not only to avoid injustices, but also to avoid taxes that will seriously dislocate the economy and actually impede the war effort. If corporation taxes are raised too high, they reach the point of diminishing returns by stifling initiative and impairing the incentive to efficient and economical operations, to say nothing of weakening the corporate structure by preventing the accumulation of prudent and necessary reserves.

There is no place in the tax program for so grossly misleading a document as the report of the Vinson committee, which presents an ill-digested summary featuring in a sensational manner some cases of "extreme" profits on war contracts—in many cases very small contracts, and in all cases *before* the very high income and excess profits taxes. Such taxes are designed for the specific purpose of recapturing for the Treasury profits in excess of what is regarded as fair and necessary for the maintenance of the business mechanism in good working order. Studies of the complete data provided by the investigation show that, taking all contracts completed and assuming an average rate of taxation of 40 per cent, the average rate of return after taxes was less than 4 per cent. This is below the normal rate of return of manufacturing companies on their peace-time sales. The action by the committee reflects a degree of irresponsibility which is highly dangerous in the present emergency, since by its appeal to prejudice it may lead to unsound tax measures that could do incalculable damage to our war effort.

The proposal that has been made to apply federal taxes to outstanding issues of state and municipal securities, heretofore exempt, must also be regarded as extremely unfortunate and a move not calculated to increase the citizen's confidence in the good faith of his Government. The application of federal taxes to future issues of these securities is a debatable economic question; but the application of taxes to outstanding issues that have been purchased by investors in good faith is in a different category.

It is true that the Government has entered into no contract not to tax these securities. But this is a technical and legalistic rather than a moral distinction. The Federal Government has acquiesced in the tax exempt status of these issues, and investors have bought them at low income rates which have yielded substantial benefits to the borrowing communities. By purchase at these low yields they are in effect already paying a heavy tax. For the Government to change the rules now would be regarded as a breach of trust by millions of investors, whether themselves holders of municipal securities or not. Is it wise or worth while to raise this issue of good faith, at a time when people are being asked to take billions of new federal issues, all for at most an estimated $200,000,000 a year of additional revenue?

Need for Governmental Economy

No mention has been made of the possibilities of cutting further the government's nondefense expenditures. Of course, every dollar of saving in non-essential spending by government goes as far towards reducing the deficit

and inflation menace as every dollar of new taxes. While the President in his budget message estimated cuts in non-defense items other than public debt interest at about $900 millions, the Byrd Committee in its preliminary report indicated possible savings of $1.7 billion, and a recent study by the Brookings Institution put the total at slightly over $2 billions. Before people are called upon for more taxes they should have assurance that the Government is practicing the same frugality that it is urging upon its citizens.

The states and municipalities can likewise play their part by practicing economy and utilizing increased revenues either to retire debt or reduce taxes and thus help clear the way for the federal tax program and strengthen their own positions.

Canadian Wartime Economic Policies

The extension of our economic cooperation with the Dominion of Canada has been an immediate and logical outgrowth of our entry into the war. The announcement by President Roosevelt on December 22 of a program calling for virtual pooling of the productive resources of the two countries, looking toward removal of tariff and other barriers to the free flow of war supplies, carries forward a policy of increasingly close collaboration begun shortly after the fall of France in the Spring of 1940.

Demands upon the industries of Canada are constantly expanding. Yet, with the unemployed margin of her own resources largely absorbed and with the acceleration of our own armament, it is becoming increasingly difficult for her to get supplies from us. Both countries have reached the point where the increase of war production must be met largely by contracting the economy in other directions. In these circumstances, it is imperative that vital materials and supplies be allocated to promote their most effective use regardless of international boundaries.

The progress of Canadian armament, and the methods by which the Canadian people have been meeting the economic problems of war, have been followed with great interest in this country, for in many respects their problems have been similar to our own. Like us, Canada had only a small military establishment before the war and practically no war industry, and has had to develop both under great pressure. Canada, however, even more than the United States, had to start from scratch, for already we were a strong naval power and had a large diversified industrial capacity available in part at least for conversion to war purposes.

At present, Canada has a total armed force of over 500,000 men, of which over 387,000 are voluntarily enlisted for service anywhere and more than 150,000 are already overseas. Her achievements in building and equipping this force have been described in a recent Canadian report as follows:*

> This force is being supplied by our own efforts with most of the modern war equipment, for Canada is now producing five types of machine guns, as well as rifles, side arms and bomb throwers; twenty varieties of chemicals and explosives; thirteen kinds of aircraft (of which nearly 4,000 have been made or assembled since the outbreak of war), over twenty types of shells, as well as rifle ammunition, grenades, light and heavy air bombs, depth charges and anti-tank mines; tanks and motor vehicles for many purposes (about 200,000 of the latter have been made) and a large array of special material, including parachutes, radio equipment and precision instruments.
>
> The production at present of this varied armament is high, and it will soon increase considerably, as may be judged by these few monthly objectives: over 1,000 field, naval and anti-aircraft guns, 400 trench mortars, 2,000 - 3,000 machine guns, 600 tanks and universal carriers.

In considering these and following figures, it should be kept in mind that Canada has only about one-twelfth the population of this country and about one-fifteenth the national income.

To accomplish the above results has required a veritable industrial revolution. In two years capital expenditures on war plants have exceeded $600,000,000, a figure greater than the total pre-war investment in plant and equipment for the whole Canadian iron and steel and machinery industry; and many of these plants are the largest of their kind in the British Empire. In this period industrial output increased 60 per cent, or more than during the entire war period of 1914-18. Probably few people in this country realize the profound changes taking place in the Canadian economy, which are bound to have lasting effect upon the economic structure and Canadian post-war trade relations.

Financing the War Program

The cost of the Canadian defense effort, including assistance to Great Britain, rose from about $34,000,000 in 1938-39 to over $2,300,000,000 for the 1941-42 fiscal year ending this March. A review of the methods of financing this great increase falls naturally into two parts: first, the period of under-capacity production when the economy was engaged in taking up slack; and, second, the period after operations had reached the zone of full capacity when the problem was one of diverting labor and materials from non-essential production, and of checking civilian consumption.

Canada, like the United States, entered upon its armament program with a considerable surplus of labor and industrial capacity and had in addition the United States to draw upon. There was thus no great need at first to divert labor and supplies from civilian to war purposes, or discourage civilian spending, especially in the low income groups.

Accordingly, the first war budget of September 1939 was relatively mild, providing for a surcharge of only one-fifth on the personal

*From the annual report of the Canadian Bank of Commerce, December 9, 1941.

and corporate income tax, an excess profits tax to check profiteering, and commodity tax increases mainly on liquor and tobacco. The first borrowing operation — a $200,000,000 two-year 2 per cent loan — was placed purposely with the banks to expand credit and purchasing power as a stimulant to total production.

With the Dunkirk disaster, however, the situation changed radically. Both the building up of the armed forces and of the industrial plant to support them was vastly speeded up. By the Fall of 1940 skilled labor had become scarce and much of the slack in industrial capacity had been taken up. Shortage of farm labor had become acute, particularly in the dairy industry where increased production was badly needed.

To speed the shift to a war economy, the second and third war budgets imposed drastic tax increases. In June 1940 the excess profits tax was raised to 75 per cent, with the minimum at 12 per cent of net taxable income, which in April 1941 was increased to 22 per cent. Taken in conjunction with a regular corporation tax at 18 per cent, this means a minimum base for corporations at 40 per cent of total net income.

Canadian personal income taxes were also drastically increased, and exemptions lowered to $750 for single persons and $1,500 for married persons. In addition, a National Defense Tax was introduced and based on the *whole* income of single persons earning more than $660 a year and married persons earning more than $1,200 a year, and is deducted at the source. The rate is 5 per cent, except in the case of single persons earning more than $1,200 a year, who have to pay 7 per cent. The net effect of these changes is as follows:

Canadian Income Tax, Plus National Defense Tax
(All Earned Income)†

	Single Person		Married Person No Children	
Income*	**Pre-War**	**Present**	**Pre-War**	**Present**
$700	....	$35	....	....
$1,300	$13	$174	....	$65
$1,800	$36	$286	....	$135
$2,400	$68	$448	$18	$255
$3,600	$148	$815	$80	$555
$5,000	$265	$1,333	$177	$1,000
$10,000	$910	$3,600	$754	$3,080
$25,000	$5,073	$12,083	$4,757	$11,185
$50,000	$14,832	$27,653	$14,458	$26,225
$100,000	$39,099	$61,608	$38,620	$59,135
$500,000	$308,401	$392,980	$307,746	$382,380

*The Canadian law does not allow any deduction for other taxes, interest on personal indebtedness, or losses on personal property, and there are no tax-exempt bonds in Canada.

†The Canadian surtax on investment income is 4% on all such income over $1500.

These tax increases obviously have compelled severe retrenchment by individuals in the middle and upper brackets, and even the lower income groups, whose aggregate earnings have increased substantially as a result of war expenditures, have been called upon for relatively large contributions. This has been accomplished by the lowering of exemptions, by the National Defense Tax, and by the high starting rate of the normal tax which is 15 per cent on the first $1,000 of taxable income, compared with 3 per cent in 1938. In addition, excise taxes have been increased, although the manufacturers, sales tax, originally levied at 4 per cent and raised to 8 per cent during the depression, remains unchanged. The latter tax, despite numerous exemptions, is calculated to yield over $200,000,000 in the current fiscal year, or about one-seventh of total revenues.

Canadian revenue collections rose from around $480,000,000 in the last pre-war year to an expected $1,500,000,000 in the present fiscal year. As a result of heavy taxes, a little more than half of total Dominion Government expenditures is now being channeled back to government. Provincial and municipal corporation and income taxes are to be suspended until after the war, thus reserving this field to the federal government which in turn will compensate the local governments in fixed annual payments.

Dominion of Canada Statistics
(In Millions of Canadian Dollars)

Fiscal years ending March 31	**1938-39**	**1939-40**	**1940-41**	**1941-42 (estl.)**
Budgetary expenditure				
Ordinary	519	549	498	470
War (nat. defense)	34	131	752	1,450
Total	553	680	1,250	1,920
Assistance to U.K.*	.....	84	470	900
Total financial requirements	553	764	1,720	2,820
Budgetary receipts	502	562	872	1,500
Canadian debt, gross	3,711	4,029	5,019	....
Calendar years	**1938**	**1939**	**1940**	**1941**
Nat. income paid out	3,837	4,040	4,594	....
Chartered Banks: (Oct.)				
Loans and invest.	3,138	3,552	3,407	3,713
Deposits	2,961	3,402	3,252	3,535

*Repatriation of British-held Canadian securities and estimated accumulation of sterling balances by the Canadian Foreign Exchange Control Board.

Despite increased revenues, borrowing during the first two years of war exceeded $1,200,000,000. Banks have been called upon both to absorb considerable amounts of Treasury securities directly and to give temporary assistance in financing purchases by other subscribers. Together with increased loans to industry and loans to finance the record wheat stocks, total loans and investments of the chartered banks rose by $424,000,000, or 13 per cent, from the outbreak of war to October 31, 1941. Deposits also substantially increased. Compared with the magnitude of what Canada has been attempting, this is a very modest expansion of credit.

As the armament program advanced, the need for mopping up purchasing power became more apparent. Increased effort has been made to reach genuine savings, both in the placement of public loans and in the drive to extend the

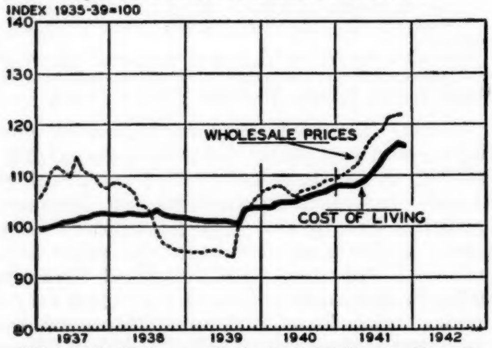
distribution of war savings certificates and stamps. In the last war loan, of June 1941, a house-to-house canvass was made and a total of 970,000 subscriptions received.

Fiscal Controls Alone Inadequate

Strenuous as have been the fiscal measures adopted to equate purchasing power with productive capacity available for civilian requirements, they have become more and more inadequate as the arms program has advanced. With national income rising and the supply of goods available for civilian use declining, the situation was becoming increasingly unbalanced.

During the first year and a half (or thereabouts) of war, it was possible for Canada to carry forward its tremendous war effort without impairment of the standard of living for the people as a whole. In fact, for many people in the low income groups the standard of living actually increased. While war costs rose from 1 per cent of the national income in 1938 to about 40 per cent in 1941, the rise in the national income itself during the period was so great that it left almost as much to spend, apart from war requirements, as before.

So long as Canada could increase the supply of goods, either by home production or imports, income spending by the public created no important problem other than that of meeting exchange requirements for goods purchased in the United States. However, by the latter part of 1941 this situation had changed and symptoms of price inflation were becoming more pronounced. Already, as the accompanying diagram indicates, prices had risen considerably since the outbreak of the war.



Wholesale Prices and Cost of Living in Canada

Adoption of Price Controls

The initial rise of prices had been due partly to the premium on U. S. exchange, higher import duties, and increased ocean freight rates, and partly to recovery in agricultural prices from abnormally low levels and to other price adjustments generally regarded as helpful to the economy. By the latter part of 1940, however, the major effect of these special factors had been felt, and the resumption and acceleration of the rise in 1941 was disquieting.

Thus Canada faced several important decisions:

(1) The Government could enact further tax increases designed to decrease spending to the shrinking volume of goods available. Taxation, however, is a relatively blunt instrument of control, and not easily adapted to the varying position of the many different taxpayers. Carried too far, it would be difficult to avoid grave injustices, demoralization of markets (in real estate, for example), impairment of work incentive, and general loss of productive efficiency.

(2) The Government could do nothing, and let the price rise take its course, relying upon higher prices to accomplish an automatic rationing of supplies. But this, too, would cause grave injustices. It would tend to cumulate in a price and wage spiral, impair morale and efficiency, enormously increase the cost of the war, and pave the way for a post-war collapse.

(3) In these circumstances, Canada chose the third method — price control, relying also, of course, upon the intensification of taxation and of the appeal to savings of all classes.

In making this decision, the next question was whether to limit the policy to selective price controls (as has been the approach in the United States), or whether to go at the problem comprehensively, through over-all price ceilings. The reasons which led Canada to adopt the latter course have been stated by a correspondent in Canada, as follows:

> Shortages were accumulating at such a rate that the selective approach could not have remained selective for long. Within a relatively short time something approximating to an over-all price ceiling would necessarily have emerged.
>
> In the meantime, those prices which were uncontrolled would have risen. This would have been unfair to producers whose prices had been controlled. It would also have impaired the balance of the price structure — which as it then existed did not have many major distortions (except for the low price of wheat) and was reasonably well adapted to drawing out the maximum production of things wanted in a war economy.
>
> A selective approach would have required the price control authority to name and justify the items which should be held down while other prices were rising. An over-all price ceiling, on the other hand, would put the onus on the producer to justify any price rise in his favor while other prices were being kept stable.
>
> Finally, a selective approach would have made ultimate stabilization more difficult, because every rise in uncontrolled prices would have brought additional and unnecessary pressure on the price ceilings which had already been established.

Effective December 1, price ceilings were established for goods at the highest levels reached during the four weeks September 15 to October 11. Included in the regulations are rents, public utility rates, transportation, warehousing, etc., but there are some exceptions, such as stocks and bonds, real estate, perishable farm goods, professional services, and works of art. Administration is in the hands

of a Wartime Prices and Trade Board, with regional offices, which must approve any increase above ceiling prices, and which has power also to set maximum prices below the ceiling level.

The Government gave special consideration to the effect upon agriculture. Farm prices were in general higher than they had been for ten years, but in some cases they had not kept pace with increasing costs of production, particularly the cost of feed. In other cases, notably wheat, prices were still considered unduly low. To safeguard total agricultural income, the Government undertook to pay transportation costs on feed grain and to make special payments to farmers in the Spring wheat area.

In general, the stated policy of the Wartime Prices and Trade Board is opposed to upward readjustments of retail price ceilings. Situations where costs exceed retail price ceilings are to be dealt with as follows (quoting again from the correspondent referred to above):

> Where costs are higher than those upon which the retail ceiling price was based, retailers, wholesalers and manufacturers will be expected to work out among themselves a fair distribution of the excess. If no agreement can be reached, the Board will investigate and decide, distributing the burden in accordance with ability to shoulder it.
>
> However, there is no intention of depriving essential enterprises of a reasonable return, and in any case where the excess costs are too great, the Board may recommend that the Government absorb part of the burden. Wherever possible, this contribution will be made at the stage of primary production or importation, and will take the form of a reduction in the cost of raw materials or imports. A Commodity Prices Stabilization Corporation is being organized with this end in view.
>
> The Prices Board may also recommend that import duties or taxes be reduced or that an outright subsidy be paid where this is necessary for the maintenance of the retail price ceiling. The Board has, of course, emphasized the immediate necessity of making economies wherever possible, particularly in the standardization of products and elimination of frills.

In other words, the policy — where irreducible costs exceed the retail price ceiling — is to spread the excess, through the Government, over the people as a whole, rather than have it fall immediately upon the consumers of the articles in question. This policy is particularly important in the case of imported goods, which bulk large in the Canadian economy but over whose costs Canada has little control.

The Policy as to Wages

Canada, however, early recognized that prices could not be stabilized without stabilization of costs, including wages, and as far back as December 1940, worked out a program covering wages in war industries. Under this plan, Boards of Conciliation were set up to which disputes had to be referred, and basic wage rates were fixed at the relatively high levels then prevailing. In special cases where basic wage rates were adjudged abnormally low, they could be increased, but otherwise increases in pay took the form of a cost of living bonus at the flat rate of 25c per week for each rise of 1 per cent in the official cost of living index. Later the plan was extended to cover all industry, under the administration of a National War Labor Board, consisting of five representatives of employers, five of employes, and an independent chairman.

By providing for cost of living increases by means of a cost of living bonus, rather than by an increase in basic wages, the Canadian plan has the great advantage of protecting the standard of living of the workers during the war period without at the same time freezing higher wage costs permanently into the price structure. The economic system retains a greater degree of flexibility for meeting post-war adjustments, including a possible decline in the cost of living.

Control Program Still on Trial

Canada's price control program has been in effect for so short a time that it is still too early to judge as to its ultimate success. Where the forces at work are so powerful and the problems so complex, only time and experience can determine the adequacy of the various regulatory measures.

There is some question, for example, how far price controls can be effective without drastic extension of rationing, with all the attendant administrative and policing difficulties. There is a question also as to the future course of American prices, since rapid increases here would obviously complicate control efforts in Canada because of the large trade between the two countries.

And, finally, of course the success of any control plan is dependent upon the willingness of the public to undergo sacrifices and to abide by the letter and spirit of the rules laid down for common observance in the emergency.

Nevertheless, despite inevitable uncertainties as to the precise working out of specific measures, it is impossible not to be impressed with the vigor and determination with which the Canadian people have tackled the huge problem of adapting themselves to a war economy. The comprehensiveness of their program, with its over-all ceilings on prices and wages, is in contrast with the program in the United States where the approach has been piece-meal and marked by glaring inconsistencies such as the action of Congress on farm products and the lack of control over wages. At the same time, it must be recognized that the establishment of a comprehensive system of price ceilings in a country of such widespread and varied industries as the United States would be a more formidable task than in Canada.

The National City Bank of New York

Head Office · 55 WALL STREET · *New York*

Condensed Statement of Condition as of December 31, 1941

INCLUDING DOMESTIC AND FOREIGN BRANCHES

ASSETS

Cash and Due from Banks and Bankers	$ 985,161,063.90
United States Government Obligations (Direct or Fully Guaranteed)	1,137,543,527.23
Obligations of Other Federal Agencies	45,756,271.71
State and Municipal Securities	164,997,544.22
Other Securities	66,145,598.43
Loans, Discounts and Bankers' Acceptances	618,810,572.66
Real Estate Loans and Securities	6,320,681.59
Customers' Liability for Acceptances	6,376,693.65
Stock in Federal Reserve Bank	4,290,000.00
Ownership of International Banking Corporation	7,000,000.00
Bank Premises	39,522,843.25
Other Real Estate	1,607.21
Other Assets	934,178.21
Total	$3,082,860,582.06

LIABILITIES

Deposits		$2,878,821,221.64
Liability on Acceptances and Bills	$13,092,737.15	
Less: Own Acceptances in Portfolio	4,495,723.27	8,597,013.88
Items in Transit with Branches		8,131,541.70
Reserves for:		
Unearned Discount and Other Unearned Income		3,843,790.51
Interest, Taxes, Other Accrued Expenses, etc.		7,475,920.77
Dividend		3,100,000.00
Capital	$77,500,000.00	
Surplus	77,500,000.00	
Undivided Profits	17,891,093.56	172,891,093.56
Total		$3,082,860,582.06

Figures of Foreign Branches are as of December 23, 1941, except Hong Kong, Shanghai, Tientsin, Peiping, Tokyo and Rangoon, which are as of November 25, 1941

$190,851,507.38 of United States Government Obligations and $13,222,359.67 of other assets are deposited to secure $176,658,677.78 of Public and Trust Deposits and for other purposes required or permitted by law.

(Member Federal Deposit Insurance Corporation)

City Bank Farmers Trust Company

Head Office · 22 WILLIAM STREET · *New York*

Condensed Statement of Condition as of December 31, 1941

ASSETS

Cash and Due from Banks	$ 63,629,028.37
United States Government Obligations (Direct or Fully Guaranteed)	45,715,480.43
Obligations of Other Federal Agencies	6,647,686.65
State and Municipal Securities	8,891,267.77
Other Securities	1,682,543.28
Loans and Advances	2,192,631.09
Real Estate Loans and Securities	5,779,724.02
Stock in Federal Reserve Bank	600,000.00
Bank Premises	3,787,076.25
Other Real Estate	245,049.74
Other Assets	1,790,439.50
Total	$140,960,927.10

LIABILITIES

Deposits	$113,531,932.79
Reserves	1,598,890.95
Capital	10,000,000.00
Surplus	10,000,000.00
Undivided Profits	5,830,103.36
Total	$140,960,927.10

$1,574,257.32 of United States Government Obligations are deposited with public authorities for purposes required or permitted by law.

(Member Federal Deposit Insurance Corporation)

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